No. 17,348

COURT OF APPEALS

for the Ninth Circuit

UNITED STATES OF AMERICA,

Appellant.

v.

DENTON J. REES and KATHRYN G. REES,

Appellees.

On Appeal from the Judgment of the United States District Court for the District of Oregon.

BRIEF FOR THE APPELLANT

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OPINION BELOW

The opinion of the District Court (R. 24-33) is reported at 187 F. Supp. 924.

JURISDICTION

This is a suit instituted against the United States for the recovery of 1955, 1956, and 1957 income taxes paid. The taxpayers filed their returns on or about April 9, 1956, March 29, 1957, and April 15, 1958,

respectively. (R. 14-15.) In addition to the amounts paid with their returns, the taxpayers paid asserted deficiencies for each of the calendar years on December 1, 1958 (R. 33.) The taxpayers filed claims for refund on March 3, 1959, and these were denied on August 24, 1959. (R. 34.) Complaint was filed on October 7, 1959 (R. 3-12, 43) within the time provided in Section 6532 of the Internal Revenue Code of 1954, for recovery of the taxes paid.

Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. Judgment was entered on November 28, 1960. (R. 39-40, 44.) Within sixty days and on January 24, 1961, the United States filed its notice of appeal. (R. 40-41, 45.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTION PRESENTED

Did the parties to this contract, which purportedly included a sale of good will by Dr. Rees to Dr. Woods and Dr. Butori, erroneously include as elements of good will certain items which were not properly includible therein, so that part of the $35,000 received by Dr. Rees was not capital gain upon the sale of good will but simply ordinary income representing his entitlement to a greater share of the partnership income than that of his partners?

STATUTE INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

* * * * *

(13) Distributive share of partnership gross income;

* * * * *

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer * * *

* * * * *

(26 U.S.C. 1958 ed., Sec. 1221.)

STATEMENT

Denton J. Rees graduated from dental school in 1935 and since then, with the exception of the period he was with the Armed Services from 1941 to 1946, he has continuously practiced his profession in Oregon. In 1953, Dr. Rees' health was poor and his practice had reached the stage where it was difficult for him to carry on without working extra hours and further damaging his health. This, together with the fact that he was finding it practically impossible to take vacations and refresher courses in orthodontia, in

which he was specializing, caused him to consider the advantage of a partnership arrangement with two other orthodontists, Dr. Woods and Dr. Butori. (R. 34.)

Dr. Woods graduated from dental school in 1945 and after his service in the Navy entered the general practice of dentistry in Portland. In the summer of 1947 he commenced taking a special course in orthodontia at the University of Illinois. He received his master's degree in 1949 and immediately began to practice orthodontia in Portland. For a considerable time, he was a part-time instructor of orthodontia at the University of Oregon Dental School. He continued this practice until he was called into the Armed Services during the Korean War in March, 1953 (R. 34-35.)

Dr. Butori graduated from dental school in February, 1946, and after serving in the Armed Forces practiced in Portland from 1948 until October, 1951. At that time he took special training in orthodontia at the University of Washington. He received a master's degree in 1953 and became associated with Dr. Woods in the practice of orthodontia. (R. 35.)

The association of Dr. Woods and Dr. Butori continued until they entered into partnership with Dr. Rees. Dr. Woods and Dr. Butori were well acquainted with Dr. Rees and with the extent of his practice and the fact that he was one of two dentists in Portland who was a member of the American Board of Orthodontia, a very prestigious group. Dr. Woods and Dr. Butori had established a professional reputa-

tion of their own, but felt that they would greatly expedite their advance in the profession and would substantially increase their income if they formed a partnership with Dr. Rees. They had been practicing under a profit-sharing agreement and were not willing to enter into the partnership arrangement with Dr. Rees other than on an equal basis. (R. 35-36.)

During the discussions leading up to the formation of the partnership and the drafting of the agreement, the dentists considered that Dr. Rees should fairly be paid a substantial sum for good will. They considered Dr. Rees' fine reputation, both in their profession and with members of the public, which resulted in many referrals to his office by other dentists and by patients who had received satisfactory treatment. They also considered Dr. Rees' personal contacts, and the benefits which would accrue to them by operating on a clinic basis. The District Court found that they concluded that a fair price for them to pay to Dr. Rees for good will would be $35,000. (R. 35-36.) There was evidence, cited by the District Court in its findings of fact, that the parties took into consideration the following factors in arriving at the total to be paid for good will (R. 36):

(1) The professional skill and reputation of Dr. Rees;

(2) The fact Dr. Rees was grossing approximately $80,000 per year from his individual practice while Dr. Woods and Dr. Butori together were only grossing $40,000 per year;

(3) The absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership;

(4) The number of prospective patients which Dr. Rees had interviewed for possible treatment in the future;

(5) The suitability of the location of Dr. Rees' office for the practice of orthodontics on a clinic basis.

The contract of sale under which Dr. Rees sold good will to Dr. Butori and Dr. Woods contains the following paragraphs (R. 36-38):

1. Sale of Interest in Business. The Seller shall sell to the Purchasers an interest in and to the practice of the Seller operated in the Selling Building, Portland, Oregon, including the good will of the practice, the lease to the premises, and a like percentage of all furniture, fixtures, supplies and equipment now devoted to said practice, with such changes that occur, up to the date of closing, in the normal course of business operation, and the Seller shall enter into an agreement of copartnership with Purchasers whereby the parties hereto shall share the profits and losses equally.

2. Exclusions. This sale does not include any cash on hand or in banks at the date of closing. Nor does this sale include any accounts receivable due to the respective parties at the date of closing, nor amounts received after date of closing for dental work done prior to the date of closing. For the purpose of this agreement dental work done before the date of closing shall include only so much of the treatment to each patient as shall have been completed before the date of closing.

6. Purchase Price. The purchase price of all the assets referred to in paragraph 1 is $40,000.00 of which $35,000.00 is attributable to the good will of Seller's established practice. (See Exhibit "A" attached for detailed breakdown of assets

> other than good will). The sum of $100.00 in cash, or by certified check, shall be paid to the Seller at the time of closing. The balance of $39,900.00 shall be paid by the purchasers to the Seller in equal monthly installments over a period of 10 years or sooner at the option of the Purchasers, until the unpaid balance of $39,900.00, without interest shall have been paid in full. . . .

Pursuant to the agreement of sale, Dr. Woods and Dr. Butori paid Dr. Rees $17,000 in 1955, $17,000 in 1956, and $3,000 in 1957, all of which Dr. Rees reported as long-term capital gain from the sale of capital assets. (R. 16-17.) A bill of sale, as provided in the sales agreement, was executed by Dr. Rees when payment was completed. Dr. Woods and Dr. Butori reported their income from the partnership as provided by the terms of the partnership agrement. (R. 38.)

The District Court held that Dr. Rees had sold good will to Dr. Woods and Dr. Butori, and the payments received therefor were capital gain. (R. 38-39.)

STATEMENT OF POINT TO BE URGED

The District Court erred in allowing the parties to this contract, which purportedly included a sale of good will by Dr. Rees to Dr. Woods and Dr. Butori, to include as elements of good will certain items which were not properly includible therein, so that part of the $35,000 received by Dr. Rees was not capital gain upon the sale of good will but simply ordinary income representing his entitlement to a greater share of the partnership income than that of his partners.

SUMMARY OF ARGUMENT

In concluding that Dr. Rees sold good will to Dr. Woods and Dr. Butori for $35,000, the District Court permitted the parties to take into consideration certain elements of the transaction which we believe were not properly includible in good will. To the extent that the District Court permitted the inclusion of good will of these impermissible elements, it is our contention that Dr. Rees actually received ordinary income rather than capital gain. The mere labelling of certain considerations as elements of good will does not automatically make them such. Here the District Court found that among the factors considered by the parties in determining the value of Dr. Rees' good will to be sold were the fact that he had been grossing approximately $80,000 per year from his individual practice while Dr. Woods and Dr. Butori together had been grossing $40,000, plus the fact that Dr. Woods, while receiving an equal share of the new partnership's income under the partnership agreement, was actually going to be absent for a year. These are not elements of good will within this Court's definition of the term as "those imponderable qualities which attract the custom of a business." Rather they are recognition of the fact that Dr. Rees was actually entitled to a greater share of the future partnership's income than his less successful (or absent) partners. Such assignment of future income results simply in ordinary income and not capital gain. The other elements considered by the parties in valuing good will

would appear to be relatively minor compared to those which were erroneously included. The judgment should be reversed for the taxpayer's failure to prove what part, if any, of the $35,000 paid to him, purportedly for good will, was in fact entitled to treatment as such.

ARGUMENT

The District Court erroneously held the entire payment of $35,000 to Dr. Rees to be capital gain upon his sale of good will, whereas, in determining this price for good will, the parties took into consideration certain impermissible elements which were not actually elements of good will, but rather which represented recognition of Dr. Rees' entitlement to a greater share of the partnership's ordinary income than the other parties.

In concluding that Dr. Rees sold good will to Dr. Woods and Dr. Butori for $35,000, the District Court permitted the parties to take into consideration certain elements of the transaction which we believe were not properly includible in good will. To the extent that the District Court permitted the inclusion in good will of these impermissible elements, it is our contention that Dr. Rees actually received ordinary income rather than capital gain. It is plain that the parties' mere lumping, under the label of good will, of numerous considerations for which a payment was made does not automatically render the entire payment or any of it a capital expenditure or receipt for good will. *O'Rear* v. *Commissioner,* 80 F. 2d 473 (C.A. 6th); *Commissioner* v. *Chatsworth Stations, Inc.,*

282 F. 2d 132 (C.A. 2d); *Horton* v. *Commissioner,* 13 T.C. 143. Likewise an item labelled as something other than good will may in fact be an element of good will. *Dodge Brothers* v. *United States,* 118 F. 2d 95 (C.A. 4th); *Masquelette's Estate* v. *Commissioner,* 239 F. 2d 322 (C.A. 5th). Since the $35,000 here held to have been paid to Dr. Rees for good will was not comminuted into the amounts attributable to each of the several elements included under the label good will, it is our belief that, if impermissible elements were included, the case must be reversed for the taxpayers' failure to have carried their burden of proving the amount of capital gain to which they were entitled upon the sale of good will. *Commissioner* v. *Chatsworth Stations, Inc.,* 282 F. 2d 132 (C.A. 2d).

The District Court here cited evidence that the parties took into consideration the following in arriving at the total to be paid to Dr. Rees for good will (R. 36):

> (1) The professional skill and reputation of Dr. Rees;
>
> (2) The fact Dr. Rees was grossing approximately $80,000 per year from his individual practice while Dr. Woods and Dr. Butori together were only grossing $40,000 per year;
>
> (3) The absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership;
>
> (4) The number of prospective patients which Dr. Rees had interviewed for possible treatment in the future;
>
> (5) The suitability of the location of Dr.

> Rees' office for the practice of orthodonics on a clinic basis.

In its opinion the District Court stated (R. 31):

> As I read the record in this case, the sum of $35,000 was agreed upon by the parties as the value of the good will after taking into consideration all of the factors above mentioned.

This statement of the District Court is clearly correct, based upon the testimony of Dr. Rees himself (R. 74, 95-98) and that of Dr. Woods (R. 113-114). However, we believe that the court erred as a matter of law in allowing the parties to take into consideration all of these factors *in determining the value of the good will.* Specifically, we direct this Court's attention to items (2) and (3), i.e., the fact that Dr. Rees was grossing approximately $80,000 per year while Dr. Woods and Dr. Butori together were grossing only $40,000 per year, and the absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership. There is no definition of good will of which we are aware which would permit the inclusion of such factors. On the contrary, these are factors which indicate that part at least of the $35,000 payment to Dr. Rees was in consideration of his future earning power, which was recognized to be greater than that of Dr. Woods and Dr. Butori, plus the fact that Dr. Woods, although sharing the partnership's income equally with the others under the partnership agreement (R. 81), was actually going to be absent for a year (R. 96-97). Payment for such considerations is, we submit, recognition of the fact that the taxpayer is entitled to a greater share of the income of the firm

than his less successful (or absent) partners. *O'Rear* v. *Commissioner,* 80 F. 2d 473 (C.A. 6th). The effect of increasing Dr. Rees' annual income after formation of the partnership was obtained by spreading out the payments to him over a period of at least three years, *viz.,* $17,000 in 1955, $17,000 in 1956, and $3,000 in 1957. (R. 16-17.) To the extent these payments were made in recognition of Dr. Rees' entitlement to a greater portion of the partnership's income than his younger partners, they represented, simply, ordinary income and not gain from the sale of a capital asset. Cf. *Commissioner* v. *P. G. Lake, Inc.,* 356 U.S. 260; *Hort* v. *Commissioner,* 313 U.S. 28; *Leh* v. *Commissioner,* 260 F. 2d 489 (C.A. 9th).

In *Grace Bros.* v. *Commissioner,* 173 F. 2d 170, 175-176, this Court discussed the meaning of good will and defined it as follows:

> It is the sum total of those imponderable qualities which attract the custom of a business, —what brings patronage to the business. Mr. Justice Cardozo, in a famous case has called it "a reasonable expectancy of preference * * * (which) may come from succession in place or name or otherwise to a business that has won the favor of its customers." *Matter of Brown's Will,* 1926, 242 N.Y. 1, 6, 150 N.E. 581, 582, 44 A.L.R. 510.
>
> The Supreme Court has held it to mean "every positive advantage that has been acquired by the old firm in the progress of its business, whether connected with the premises in which the business was previously carried on, or with the name of the late firm, or with any other matter carrying with it the benefit of the business." *Menendez* v. *Holt,* 1888, 128 U.S. 514, 522, 9 S. Ct. 143, 144, 32 L. Ed. 526.

Plainly, the fact that Dr. Rees was grossing $80,000 per year as compared to $40,000 for Dr. Woods and Dr. Butori together is not an element of good will within this definition; nor is the absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership. These are not includible among "those imponderable qualities which attract the custom of a business." No one could reasonably be expected to patronize the clinic because Dr. Rees' gross income had been twice as high as that of Dr. Woods and Dr. Butori together (even assuming that that was generally known). Nor is there any reason on this record to suppose that the clinic would gain patronage because Dr. Woods was to be absent for a year. The inclusion of these factors in good will, we submit, is untenable on its face, and clearly not within the understanding of this Court as to the meaning of the term.

While such factors as Dr. Rees' professional skill and reputation, the fact that he had interviewed prospective patients, and the desirable location of his office might be considered as proper elements of good will within this Court's definition (see *Rainier Brewing Co.* v. *Commissioner,* 7 T.C. 162, 176, affirmed *per curiam,* 166 F. 2d 324 (C.A. 9th); *Webster Investors, Inc.* v. *Commissioner* (C.A. 2d), decided June 9, 1961 (7 A.F.T.R. 2d 1611, 1613)), certain circumstances here, we submit, show their relatively small value as compared to the elements erroneously considered by the parties and the District Court as parts of good will. Thus, the name of Dr. Rees did not (nor

was it ever intended to) appear in the partnership's title of Portland Orthodontic Clinic (later changed to Portland Orthodontic Group). (R. 90-91.) In fact, the stated purpose of the partnership was not to attract or treat patients by any individual dentist within the partnership, but rather to do it on a clinic basis. Thus, Dr. Rees testified as follows (R. 91, 93, 101):

> Q. But the group was referred to and you yourself referred to this group as the Portland Orthodontic Clinic at that time?
>
> A. That is correct.
>
> Q. And it was the discussion of the clinic approach that led to the adoption and formation of this new partnership? A. That is correct.
>
> * * * * *
>
> Q. In a word, Dr. Rees, the clinic approach is quite a different approach from the individual professional practitioner approach, is it not?
>
> A. It is.
>
> Q. And in the clinic approach the clients—we do refer to them as clients, do we not?
>
> A. Or patients.
>
> Q. Or patients. Excuse me. The patients come to the group and not to a particular doctor?
>
> A. Once the group has become established that is true.
>
> * * * * *
>
> Q. In other words, Doctor, after you started the partnership you comingled [sic] the patients that you all had; isn't that correct.
>
> A. That is correct.
>
> Q. After the partnership was once commenced you may work on some of the patients that had previously been Dr. Butori's and he may work on some that had previously been yours; is that right?
>
> A. We all worked on all the patients, with very few exceptions—maybe two or three per cent that particularly want one Doctor to do it.

> We give them this choice, but I would say this has been true from the beginning, that probably 95 percent of the patients we all see and we all work on and we rotate on.
>
> Q. That was part of the negotiations of the agreement, was it?
>
> A. That was one of the principal reasons we went into this, * * *.

Accordingly, it appears that the parties here in fact intended to open a *new* practice known as the Portland Orthodontic Clinic where substantially all patients would be treated interchangeably by all dentists. That, rather than the professional skill and reputation of any single dentist, was intended to constitute the attraction and benefit of the new group. It is also worth noting that, although the desirability of the location of Dr. Rees' office was included as an element of his good will, the group obtained new quarters about a year after forming their partnership. (R. 91.)

CONCLUSION

In valuing the good will sold by Dr. Rees, the parties to the contract considered factors which are not proper elements of good will. Therefore the value attributed to the good will is necessarily erroneous, and the judgment should be reversed.

Respectfully submitted,

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AUGUST, 1961.

APPENDIX

Table of Exhibits Pursuant to Rule 18(2)(B) as Amended:

Exhibit	*Identified*	*Offered*	*Received*
1 through 12	R. 21	R. 55	R. 55
13 through 26	R. 22	R. 55	R. 55
27 through 40B	R. 23	R. 55	R. 55
41-A	R. 23, 65-66	R. 66	R. 66
41-B	R. 23, 66	R. 66	R. 66